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**Via E-Mail [pubcom@finra.org](mailto:pubcom@finra.org)**

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

**Subject: FINRA Regulatory Notice 09-15 (Limit and Market Order Protection)**

Ladies and Gentlemen,

Pink OTC Markets Inc. ("Pink OTC") respectfully submits the following comments on the proposal by the Financial Industry Regulatory Authority, Inc. ("FINRA") to adopt a new rule governing market and limit order protection based on NASD Rule 2111, NASD IM-2110-2 and NYSE Rule 92, as described in FINRA Regulatory Notice 09-15.

Pink OTC generally supports the proposal described in Regulatory Notice 09-15 to simplify the order handling rules, which should reduce the complexity of, and cost of compliance associated with, these rules. However, we believe the proposed rules should be modified to provide market makers with the incentives necessary to maintain priced quotations and thereby foster pricing competition among all market participants and promote the institution and maintenance of liquid markets in OTC equity securities.<sup>1</sup> For these reasons, we believe that (i) customer orders generally should only qualify for price improvement with respect to proprietary executions against published quotes if they use defined quotation sizes, (ii) market makers should not be required to provide price improvement for orders received while they are in the process of executing a trade for their own account and (iii) a market maker's publicly displayed proprietary quotes should have time priority over orders received after the proprietary quote is published. We also support the position of the Securities Industry and Financial Markets Association ("SIFMA") that the no-knowledge standard proposed to be applicable to NMS stocks<sup>2</sup> should also be applicable to OTC equity securities.

Pink OTC is the leading provider of pricing and financial information for the over-the-counter (OTC) securities markets and, among other things, operates Pink Quote, an Internet-based, real-time quotation service for OTC equities for market makers and other broker-dealers registered under the Securities Exchange Act of 1934 (the "Exchange Act").

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<sup>1</sup> The term "OTC equity securities" is defined in FINRA Rule 6420 to mean all non-exchange-listed securities and certain exchange-listed securities that do not otherwise qualify for real-time trade reporting.

<sup>2</sup> The term "NMS stock" is defined in Rule 600 of Regulation NMS to mean any non-option security for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.

## **Orders Entitled to Price Improvement Generally Should Use Defined Quotation Sizes**

Pink OTC has consistently supported the institution of limit order protection in the markets for OTC equity securities. We continue to believe that limit order protection provides significant benefits to investors in OTC equity securities. Moreover, we support price improvement as a means to prevent a market maker from abusing its privileged position to step ahead of a limit order by a small amount to avoid providing the execution deserved by a customer.

Nonetheless, we believe that the minimum price improvement standards currently set forth in NASD IM-2110-2, which are proposed to be incorporated into FINRA Rule 5320, are inappropriate for OTC equity securities due to the absence of minimum order or quote increments in OTC equity securities. Pink OTC believes that in cases where a market maker is taking a published quote, or whose published quote is being hit by an incoming offer, a customer's order should receive price improvement only if the customer's order uses defined quotation sizes.

At the present time, there are no minimum order or quotation increments for OTC equity securities. In contrast, order and quotation sizes for NMS stocks are limited to \$.01 for stocks priced equal to or greater than \$1.00 and \$.0001 for stocks priced at less than \$1.00.<sup>3</sup> However, Pink Quote follows the NMS standard for stock priced equal to or greater than \$1.00 per share and will not display quotations in increments less than \$.0001 for stocks priced less than \$1.00. The OTC Bulletin Board, which is the only other significant interdealer quotation system for OTC equity securities, will not accept quotations in increments of less than \$.0001 for any quoted security.

As a result, some customers take unfair advantage of OTC market makers by submitting orders that are slightly higher than the market maker's quote in increments that cannot be displayed by Pink Quote or the OTCBB. These orders are then unfairly entitled to price improvement when a market maker lifts a published quote. Fast-moving, high-volume markets seem to offer the most opportunity for profiting from this sort of unfair "scalping" behavior.

For example, suppose the market for OTC equity security ABCD is quoted on Pink Quote at 1.10 bid and 1.11 ask. A customer order is entitled to price improvement at any price greater than 1.105. A customer seeking to take unfair advantage of a market maker will place a buy order at 1.1051, a price that cannot be displayed on Pink Quote. If the market maker takes the published asked price at 1.11, it will then be instantly scalped by the customer because the market maker is required to provide price improvement at a loss to the customer order at 1.1051.

The same unfair scalping behavior can occur when a market maker's quote is hit by an incoming offer. Assuming the same market for OTC equity security ABCD as in the prior

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<sup>3</sup> Exchange Act Rule 612.

paragraph, a market maker with a quoted bid at 1.10 would be required to fill a customer order to buy at 1.1049 at a loss when the market maker's quote is hit by an incoming offer at the quoted bid price.

This situation could not exist with an NMS stock because the market maker could not accept an order at 1.1051 or 1.1049. At any price that an order could be accepted, no price improvement would be required where a market maker simply lifts an existing published asking price. Requiring a market maker to provide price improvement at a loss to a resting order when a market maker is executing against a published quote, or whose published quote is being taken, is unfair because the customer could have taken the published quote at any time simply by submitting an order at that price.

We believe this is an unintended consequence of FINRA IM-2110-2, which instituted price improvement increments to OTC equity securities without also setting the corresponding quote and order increments required for NMS stocks. We do not believe FINRA ever intended for market makers to lose money on trades that merely involve executions against an existing published quotation. The rule in its current formulation encourages customer gaming and discourages market makers from submitting priced quotations into interdealer quotation systems. The effect is to reduce transparency and liquidity in the market for OTC equity securities, a result that punishes all market participants for the misdeeds of a few.

The situation is not adequately corrected by increasing the number of increments that can be quoted in interdealer quotation systems. At any number of decimals, it will always be possible to submit orders priced at increments that will not be accepted by Pink Quote or OTCBB. Moreover, an increase in the number of increments is costly for market participants to implement and results in an enormous increase in the volume of quote traffic on industry networks. Among other things, increased decimal points results in flickering quotes and less transparency for market participants. For the same reasons that Reg NMS limits the increments at which orders can be accepted or quoted in industry systems, the additional cost of increased increments is not a sensible expense because it will not improve the market for OTC equity securities.

We therefore propose that FINRA adopt for purposes of FINRA Rule 5320 the same rule for OTC equity securities that applies to NMS stocks priced at \$1.00 or more per share. Broker-dealers should not accept orders, and should not place quotes into interdealer quotation systems, that are denominated in less than \$.01 increments.

For OTC equity securities priced at less than \$1.00, we do not believe that market makers should ever be required to provide price improvement for amounts that are less than one percent of the per share quoted price. One percent is the minimum amount of price improvement required under Exchange Act Rule 612 for stocks priced at \$1.00 per share. Market makers should not be permitted to quote or accept orders at increments that would not permit at least one percent price improvement.

In the event that FINRA determines that it would not be appropriate to regulate quote and order increments in OTC equity securities at this time, other alternatives would restore fair dealing to the market place. For example, FINRA can adopt an exception to limit

order protection that would protect customers with limit orders at published increments, but would not require price improvement in cases where the market maker is simply taking a published quote or whose published quote is being hit. Under this alternative, legitimate limit orders would still be protected from trade-throughs without requiring a market maker to lose money on a trade that simply responds to a published quote.

It is true that Exchange Act Rule 612, in the case of NMS stocks, does not provide for the one percent limitation we are proposing for OTC equity securities. However, the vast majority of NMS stocks are priced at greater than \$1.00 per share. Moreover, NMS stocks trading below \$1.00 for any extended period generally are required to be delisted under NYSE and Nasdaq rules. Accordingly, we do not believe the Securities and Exchange Commission (the "Commission") considered it useful to implement meaningful increments for NMS stocks priced at less than \$1.00 per share when it adopted Exchange Act Rule 612. In contrast, many OTC equity securities are priced at less than \$1.00 per share.

The current increments for NMS stocks, and FINRA's proposed increments for OTC equity securities set forth in SR-NASD-2007-041, for securities priced under \$1.00 would require price improvement of 100% on a percentage basis in cases where a market maker was simply accepting a published quotation. This is not appropriate and adversely impacts the market for these securities to the detriment of most OTC market participants. Neither the increments for NMS stocks, nor FINRA's proposed increment were, to our knowledge, based on any economic, statistical or academic study.<sup>4</sup>

Limit order protection is new to the markets for OTC equity securities. We believe the time has come to consider appropriate increments for orders and quotes of OTC equity securities, which are often priced at less than \$1.00 per share.

We believe that the amendments we propose to FINRA Rule 5320 to limit the scope of price protection generally to orders priced on defined increments would promote fair dealing by member firms, without unduly subjecting broker-dealers to the unscrupulous practices of those few customers who seek to game the system. This should result in a more liquid market with full and fair competition for published quotations by all market participants.

### **Orders Received When a Market Maker is in the Process of Executing a Proprietary Order Should Not Be Entitled to Limit Order Protection**

Pink OTC believes that Rule 5320 should incorporate an exception into the Rule that would relieve an OTC market maker from the obligation to execute a customer order in an OTC equity security if a proprietary order to accept a priced quotation has been sent, but has not yet executed.

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<sup>4</sup> In contrast, the increments adopted by Pink OTC resulted from an academic study performed by Professors William G. Christie and Nicolas P.B. Bollen of Vanderbilt University Owen Graduate School of Management. See Bollen, N. and W. Christie, "Microstructure of the Pink Sheets Market" (2005).

Most trade negotiations in OTC equity securities occur through the use of our Pink Link system, which is a proprietary messaging system designed for market makers to communicate to other market makers offers to accept a priced quotation. Other transactions are negotiated by telephone. At the present time, there is approximately a 9 second delay between the sending of a Pink Link message to accept a priced quote and the resulting execution in Pink Quote only securities and an 11 second delay in securities dually quoted on the OTCBB. Telephonic executions take more time to accomplish. We believe that if a market maker can document that it has initiated a proprietary trade before a customer limit order is received, the customer order should not be entitled to receive the resulting execution.

The exception we propose is currently available for NMS stocks. Exchange Act Rule 602 provides that a customer order for an NMS stock is not entitled to an execution with respect to a proprietary transaction if the customer order is received while a market maker is in the process of executing the proprietary transaction.<sup>5</sup> We do not believe there is any valid justification for having a different rule for OTC equity securities.

The current situation with OTC equities is similar to the circumstances that existed with Nasdaq securities prior to the implementation of SuperMontage. The NASD's published interpretations of the order protection rules at that time provided an exception from limit order protection for proprietary transactions that were in the process of execution at the time the limit order was received. For example, NASD Notice to Members 95-60 (at p. 17) states that market makers are permitted "up to 20 seconds to decline a non-directed order, if such action is consistent with the SEC's firm quote rule, Rule 11Ac1-1. In other words, if the market maker, immediately before the presentment of the N<sup>o</sup>Aqcess order effected a trade and was in the process of updating its quotation to reflect that transaction, the market maker is permitted to decline the N<sup>o</sup>Aqcess order."

Broker-dealers should receive equal protection and have equal obligations regardless of the venue upon which the security is listed or traded. Any other rule would be disruptive to the orderly functioning of the market for OTC equity securities. Accordingly, we believe that FINRA should amend proposed Rule 5320 to provide for proprietary transactions in OTC equity securities an exception similar to that provided for NMS stocks when a Pink Link message is sent (or a telephonic communication is commenced) before a customer limit order is received, even though the resulting execution message or telephonic confirmation may be received after the customer order is received.

## **Priority of Initial Quotation**

Pink OTC believes that a market maker that publicly publishes a proprietary quote in an interdealer quotation system should receive time priority to buy (or sell) the shares

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<sup>5</sup> Section (b)(3)(ii)(B) of Rule 602 of Regulation NMS provides, in relevant part, "No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (b)(2) of this section if: ... (B) At the time the order sought to be executed is presented, such responsible broker or dealer is in the process of effecting a transaction in such subject security, and, immediately after the completion of such transaction, such responsible broker or dealer communicates to the exchange or associate pursuant to paragraph (b)(1) of this section, a revised bid or offer...."

represented by the proprietary quote before owing them to a customer limit order at that price, if the customer limit order is received subsequent to publishing the quote. For example, suppose a market maker publishes a bid for 5,000 shares at \$9.00. The market maker then receives a customer order to buy 10,000 shares at \$9.00. The market maker should be able to buy his 5,000 shares at \$9.00 (his original bid and order size) without being obligated to fill the customer order. (If a customer bids a better price than the market maker's published quote, the customer's order would then, of course, have precedence.)

Pink OTC believes that implementation of a rule establishing this time priority would build published liquidity and reward market makers for quoting increased sizes. The time priority would prevent customers from getting ahead of a market maker's established price quote, increase the publicly displayed quotation sizes of market makers and incentivize better pricing by both market makers and customer limit orders all of which would encourage open and fair competition among all market participants. While a market maker's quote would have precedence over a later received customer limit order at the same price, most customer orders would benefit from the increased displayed liquidity that is generated by a time priority rule.

The proposed time priority amendment is consistent with the rules adopted by the New York Stock Exchange (the "NYSE") in connection with its institution of the Designated Market Maker ("DMM"), which replaced the NYSE Specialist. When the NYSE replaced the Specialist with the DMM, it also revised the rules regarding priority of executions. The Specialist had previously always yielded priority to Off-Floor Participant orders entered on the Display Book. The new rules give the DMM priority in executions in circumstances where the DMM establishes the quotation prior to other orders.<sup>6</sup>

In its adopting release, the NYSE argued that the modified trading model, which give priority to DMM orders established prior to other orders, was required "in order to adapt to the current equities market environment" and to "allow all participants the ability to compete efficiently consistent with the participant's respective responsibilities to the market."<sup>7</sup> The NYSE's new model sought "to strike a balance among market participants that retains a role for liquidity providers responsible for maintaining fair and orderly markets, agents on the Floor, and Off-Floor participants...[and] will improve market

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<sup>6</sup> The NYSE's new priority rules provide that, "where there is more than one bidder (offeror) participating in an execution and one of the bids (offers) was established as the first at a particular price and such bid or offer is the only interest when such price is or becomes the best bid or offer published by the Exchange (the "Setting Interest"), the displayed portion of such Setting Interest is entitled to priority." The displayed (i.e. quoted) portion of the Setting Interest is established as the Priority Interest. Under the new model, the first 15% of any execution (in rounded lots) will be allocated to the Priority Interest. For the remainder of the execution, the Setting Interest receives parity with other interest available at that price. The Priority Interest retains its standing during the trading day even if the Exchange BBO moves away from its price point and then moves back (i.e. it retains priority until it is exhausted). Even in the absence of a Setting Interest, the new model divides equally (where possible) the executing order among the market participants (i.e. the single Off-Floor Participant, the DMM, and each Floor broker). See SEC Release 34-58845, October 24, 2008, at 23-24, and SEC Release No. 34-58184, July 17, 2008, at 63-65.

<sup>7</sup> SEC Release No. 34-58184, July 17, 2008, at 32.

quality in the form of tighter spreads, greater liquidity and opportunities for price improvement.”<sup>8</sup>

We believe the rationale for the NYSE’s time priority rule for DMM orders applies with equal force to market makers in the OTC markets. Providing an OTC market maker time priority if its quotation has been established prior to the receipt of a customer order will, like NYSE’s new trading model, “create a market model where all participants have the ability to compete.”<sup>9</sup>

## **The No-Knowledge Exception Should Be Adopted**

Pink OTC supports FINRA’s codification of the NYSE no-knowledge standard in its proposed Rule 5320.02. Pink OTC believes, however, that the no-knowledge standard proposed to be applicable to NMS stocks should also be applicable to OTC equity securities and does not believe that FINRA has good reason to support the imposition of a different standard for OTC equities than for NMS stocks. While Pink OTC agrees with FINRA that the NMS market has evolved, making FINRA’s prior approach to the no-knowledge exclusion obsolete, Pink OTC does not agree with FINRA’s view that the market for OTC equity securities has not evolved as well.

Pink OTC agrees fully with the comments expressed on this point by SIFMA in their Comment Letter dated April 30, 2009 submitted to FINRA in connection with Regulatory Notice 09-15 (the “SIFMA Comment Letter”).<sup>10</sup> We agree with SIFMA that, in many cases, the markets for NMS stocks and OTC equity securities currently operate in the same manner. We also believe, as does SIFMA, that the OTC market is indeed evolving in the same manner as the NMS market, and that such evolution warrants the adoption of the NYSE standard for the OTC market as well as the NMS market. We agree with SIFMA that, “[s]uch a change would provide firms with the flexibility to adapt their order routing practices as changes occur without sacrificing customer protection.”<sup>11</sup>

Pink OTC also agrees with SIFMA that the adoption of two different standards is inconsistent with the stated intentions of harmonization between FINRA and NYSE, which is to bring consistency to FINRA’s rule set. We agree, as does SIFMA, that FINRA’s current proposal would do just the opposite and would “impose the legacy NYSE standard on the exchange securities and impose the legacy NASD standard on OTC securities. Such an approach introduces unnecessary complexity into the Proposed Rule, where the goal of customer protection would be appropriately served by the application of the NYSE no-knowledge standard to both exchange-listed and OTC securities.”<sup>12</sup> Pink OTC additionally believes that adoption of a harmonious standard for NMS stocks and OTC equity securities would facilitate compliance and programming efficiencies.

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<sup>8</sup> Id., at 33.

<sup>9</sup> Id., at 62.

<sup>10</sup> See SIFMA Comment Letter, Comment I.B.

<sup>11</sup> SIFMA Comment Letter, at p. 6.

<sup>12</sup> SIFMA Comment Letter, at p. 6.

## Conclusion

The goal of limit order protection is to promote active and liquid markets in OTC equity securities, where orders received from many sources can compete for executions. For that reason, we support limit order protection for OTC equity securities.

Nonetheless, this salutary goal can only be achieved if all market participants are treated fairly. We think the current rules permit gaming by some market participants, particularly in markets characterized by high volume trading. The same issues plagued Nasdaq and other markets for NMS stocks for many years, but were solved through the implementation of quote and order increments. This same experience should be used to modernize the markets for OTC equity securities.

The pre-SuperMontage Nasdaq market also confronted issues of timing where a market maker was in the process of executing an order when a new customer limit order at the same price was received. This problem was solved by creating an exception to the limit order protection rule to avoid market disruption. A similar exception is required in the market for OTC equity securities.

Most recently, the NYSE has adopted time priority rules for its new DMM participants. We think this is a useful development that encourages market liquidity to be publicly displayed and promotes fair competition among all market participants.

Finally, we agree with SIFMA that it would be a mistake to impose legacy NASD standards on the market for OTC equity securities in adopting the NYSE “no-knowledge” standard.

Much has been learned over the last two decades regarding limit order protection. There is no need to repeat past mistakes and the many starts and stops that confronted the industry and its regulators over this historical period. We should draw from the experience of Nasdaq and the NYSE to implement an approach to the protection of customer orders in the market for OTC equity securities consistent with current technology that fosters the development of active, fair and liquid markets where all market participants compete on a level playing field for executions.

Please call if you have any questions or require any additional information.

Very truly yours,



R. Cromwell Coulson  
Chief Executive Officer